

Research Department  
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## Interest Rate Target?

Alice Rivlin, Director of the Congressional Budget Office, recently asked whether the Federal Reserve could improve the form in which it reports its monetary-policy intentions to Congress. In testimony before the House Banking Committee, she argued that the problem is “how to set monetary policy goals in a more meaningful way than ranges of growth in monetary totals”—and suggested that the best alternative is probably an interest-rate target.

Under the current reporting procedure, the Federal Reserve lays out for a year ahead its targeted rates of growth for a group of monetary aggregates—such as  $M_1$  (currency plus bank demand deposits) and  $M_2$  ( $M_1$  plus bank time deposits except large CD's). This May, for example, Chairman Arthur Burns testified that the Fed intended  $M_1$  to grow at a rate between  $4\frac{1}{2}$  and 7 percent over the upcoming year.

### Problems with aggregates

Outside observers sometimes claim difficulty in interpreting such numbers. For one thing, the Chairman testifies on the Fed's monetary targets every three months, but the targets cover a 12-month period. The Fed then revises these plans three months later. In his previous February testimony, for example, the Chairman indicated that the Fed desired  $M_1$  to grow at a rate between  $4\frac{1}{2}$  and  $7\frac{1}{2}$  percent, with the upper boundary  $\frac{1}{2}$  percent higher than the May figure.

Critics also claim that confusion arises from the fact that the aggregates are difficult to control. Under current procedures, the Federal Open Market Committee (FOMC), a key Fed policy-making body, issues its instructions once each month to the manager of the System Open Market Account (SOMA), the Committee's operational arm. These instructions are formulated in terms of variables over which the SOMA exerts sufficient control for it to implement the FOMC instructions. However, few variables fit this criterion, and monetary aggregates are not among them. As a result, the Federal Reserve's influence over the growth in the monetary aggregates is indirect. The SOMA manipulates variables that in turn affect the quantity of money only over the long haul. Consequently, the money supply may grow at rates outside the specified growth path for long periods of time.

The monetary-aggregate targets thus are not always easy to interpret. When the aggregates grow at a rate outside the targeted range, it requires study to determine whether the Fed is changing its policy intentions or whether it is experiencing unexpected growth rates in the aggregates.

### Problems with interest rates

If targets were set in terms of interest rates, the problem of controllability would be reduced. For example, the Fed can control the average

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(weekly or monthly) Treasury bill rate with great accuracy if it should desire to do so. The FOMC needs only to instruct the SOMA to buy or sell Treasury bills whenever bill rates step outside a given range. Should the SOMA operate in this manner, short-term rates would be controlled quite closely, and Congress could see that the Fed was actually reaching its target.

However, as Rivlin indicates, interest rates are controllable but are also sometimes perverse. Suppose the Fed were to select a certain bill-rate target but GNP growth turned out to be weaker than the Fed expected. The weakness in GNP would mean weakened demand for cash, and consequently, the Fed could find itself on a wrong policy course. This policy course would provide less stimulus than desired at the level of interest rates targeted by the Fed—just at the time when the Fed would like to be supplying more (not less) credit to bolster the economy.

By the same token, if GNP should grow more rapidly than expected, and if this growth should be accompanied by boom-level credit demands, the Fed's adherence to its interest-rate target would lead it to provide more credit than it had intended—rather than less, as it

would like. The result could be an upsurge of undesired inflationary pressures.

In broad terms, the choice between a monetary-aggregate target and an interest-rate target seems to come down to this—a choice between 1) variables (the monetary aggregates) that tend to wander off course and 2) a variable (the Treasury bill rate) that is more easily controlled in the short-run but that tends to magnify policy errors when left unchanged over extended periods of time.

### **Rivlin approach**

In her Congressional testimony Rivlin suggested a compromise—"a target range of monetary growth which could be followed *provided* that some short-term interest rate—say the Treasury-bill rate—did not rise above some specified level." Under such a procedure, the Fed would realign its monetary-aggregate targets each time interest rates rose above their expected levels. It stands to reason, of course, that the Fed would indeed rethink its policy plans whenever interest rates behaved in an unexpected way. But if this were the only consideration that led the Fed to revise its decisions, policy might still fail to achieve the desired ultimate goals of the economy.

Early this year, for example, short-term interest rates declined, in contrast to what most analysts had expected. This information, if considered by itself, would lead the analyst to suspect a weakening of the economy, and therefore would indicate the need for a higher, not a lower, monetary-aggregate target. But most economic indicators indicated at that time that the recovery was proceeding at a relatively healthy pace. Indeed, the lower end of the targeted money-growth range was reduced in February—rather than increased, as the interest-rate information would suggest if it were considered alone.

Thus, adding a specific interest-rate target to the present monetary targets might not be helpful, since interest rates represent only a part of the story. If the Treasury-bill rate is not the variable the Fed sets out to control, there is a question why it should be singled out at all for a special role. The role of interest rates, like the role of the monetary aggregates, should be determined by the contribution it can make to the Fed's long-term objectives of high employment, sustainable growth and price stability.

**Kurt Dew**

#### PACIFIC BASIN STATISTICAL PUBLICATION

The Federal Reserve Bank of San Francisco has begun publishing the *Pacific Basin Economic Indicators* on a quarterly basis. The publication is a compendium of statistics giving annual rate of change data for 13 Pacific Basin countries on gross national product, money supply, international reserves, consumer prices, wholesale prices, manufacturing employment, industrial production, imports and exports. The countries included are Australia, Canada, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand, and the United States.

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**BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT**  
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 5/12/76	Change from 5/ 5/76	Change from year ago	
			Dollar	Percent
Loans (gross, adjusted) and investments*	87,316	- 291	+ 2,127	+ 2.50
Loans (gross, adjusted)—total	65,635	- 118	+ 876	+ 1.35
Security loans	1,194	- 35	+ 237	+ 24.76
Commercial and industrial	22,287	+ 20	- 1,546	- 6.49
Real estate	19,843	+ 46	+ 197	+ 1.00
Consumer instalment	11,007	+ 37	+ 1,131	+ 11.45
U.S. Treasury securities	9,470	- 168	+ 1,562	+ 19.75
Other securities	12,211	- 5	- 311	- 2.48
Deposits (less cash items)—total*	87,093	- 939	+ 1,923	+ 2.26
Demand deposits (adjusted)	24,302	- 73	+ 1,176	+ 5.09
U.S. Government deposits	445	- 176	+ 140	+ 45.90
Time deposits—total*	61,139	- 186	+ 705	+ 1.17
States and political subdivisions	6,667	- 119	- 952	- 12.50
Savings deposits	26,147	+ 99	+ 6,412	+ 32.49
Other time deposits‡	26,222	- 109	- 3,302	- 11.18
Large negotiable CD's	11,119	- 172	- 4,964	- 30.86
<b>Weekly Averages of Daily Figures</b>	<b>Week ended 5/12/76</b>	<b>Week ended 5/ 5/76</b>	<b>Comparable year-ago period</b>	
<b>Member Bank Reserve Position</b>				
Excess Reserves	- 7	157		33
Borrowings	0	2		0
Net free(+)/Net borrowed (-)	- 7	+ 155		+ 33
<b>Federal Funds—Seven Large Banks</b>				
Interbank Federal fund transactions				
Net purchases (+)/Net sales (-)	+ 145	- 284		+ 1,164
Transactions of U.S. security dealers				
Net loans (+)/Net borrowings (-)	+ 558	- 325		+ 463

\*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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